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Borrowers usurp the power of lenders

by **Wietske Blee**

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Borrowers usurp the power of lenders

BY WIETSKE BLEES

PRIVATE EQUITY'S USE of leverage to enhance returns is one of the topics that has dominated discussions surrounding the buyout industry for most of last year. Ever increasing levels of liquidity and competition have boosted multiples and are commonly considered to be the 'culprits' behind the current high pricing levels. The question whether individual buyouts will be able to sustain current levels of debt repayment is also highly debated. However, while not a day goes by without some journal listing the dangers involved in what most of Europe refers to as 'risk capital,' bankers across Europe appear surprisingly relaxed about the viability of their loans. Is this a case of denial, or will the market be able to avoid a repetition of the 1990s?

Multiplying multiples

The strong performance of private equity has attracted increasing numbers of investors to the asset class. The influx of capital has had an impact, both on the way in which leveraged buyouts are being structured, and on the multiples that are being paid to realise them. In response to institutional demand, leverage structures are becoming increasingly back-end loaded, while multiples have increased as the abundance of leveraged finance enables private equity to pay higher prices for assets.

The consensus has always been that leverage multiples of 6x EBITDA should only be applied to exceptionally good deals, but statistics now indicate that this figure is close to the norm. In 2005, average debt levels stood at 5.5x EBITDA, according to Standard & Poors. Its figures also reveal that during the latter part of the year, over 40% of European buyouts were structured with debt of more than 6x EBITDA, including a number that were leveraged as aggressively as 7x and more. Include the



'Lenders have certainly lost some control over their leverage provision during the past year.'

Mark Bulmer
SEB Enskilda

equity cushion and enterprise valuations reach 8.5x a company's gross earnings and above. At the same time, while debt levels have increased substantially, the equity cushion has declined from around 40% to 20-30% for larger transactions and down to 0% after recapitalisations.

With banks ready to lend, it is the borrower that seems to be king. Erlendur Magnusson of Glitnir Leveraged Finance points out: 'We are currently in a borrower's market and borrowers are becoming more demanding when it comes to determining term sheets.' Concepts such as the equity cure, which allows a buyout house to put in additional equity to cure a cashflow shortfall, and the Mulligans clause, which states that if a covenant is breached, it is not treated as a default unless the covenant is breached again on a next attempt, are becoming increasingly familiar features in documentation. 'Lenders have certainly lost some control over their leverage provision during the past year,' says Mark Bulmer of SEB Enskilda.

However, while a trend of growing levels of debt on borrower-friendly terms and decreasing levels of equity may buoy returns, the fact that valuations are reaching historical highs is often interpreted as a cause for concern. With leverage ratios up and margins down, the market is becoming increasingly heated, perhaps even overheated. If the current low interest rates were to rise, for example, this could have painful consequences for the balance sheets of many private equity owned companies. Some argue that the question is not 'if' but 'when' the bubble will burst. How realistic are such predictions of an across-the-board meltdown, and if the outcome were this certain, why are banks still leveraging to the extent that they are?

A bursting bubble?

On one level, the capital available needs to be invested and Europe's sound macroeconomic indicators do not currently spell an imminent disaster for the leveraged finance markets. Jerry Wilson from Royal Bank of Scotland points out: 'The UK economy has proven to be remarkably resilient, and even stronger than expected following the tragic terrorist events of 11 September in New York and 7 July in London, while everybody expected these shocks to have a more prolonged negative effect.' Across Europe in general, economic prospects seem positive, particularly in those countries which have recently bounced back from more recessive years. The fact that decisions to leverage highly appear increasingly based on pro forma EBITDA figures, rather than on realised profits, indicates that many lenders expect the current climate to remain strong.

Individual characteristics of companies also indicate that there is reason to believe that higher multiples may be justified. 'Although EBITDA calculations indicate a strong rise in multiples, when looking at the cash basis which sustains these levels of leverage, companies' foundations are proving decidedly more solid,' says Mark Milders of ING Acquisition Finance, part of ING Wholesale Banking.

Nonetheless, while strong economic prospects may seem reassuring, this begs the question of what could happen if the situation were to become less benevolent. There is a possibility that the low default ratios of late may not have accurately reflected market conditions and may be subject to some corrective pressures in the future. 'Default rates are at cyclical lows due to the benign economic environment and the borrower's ability to refinance existing credits with comparative ease,' says Jonathan Guise of Blenheim Advisors, adding: 'This ratio will undoubtedly increase.' The growth in the number of distressed debt funds that have been established during the past 6-12 months indicates the strength of these expectations. Exactly how this will impact on private equity, however, is as yet unclear and especially the question as to whether private equity will be subject to a 'big bang' remains highly debatable.



'It is very unwise to copy a leverage structure that may be appropriate for a strong business and apply it to a mediocre one.'

Erlendur Magnusson
Glitnir Leveraged
Finance

A myriad of possibilities?

Some market participants believe that economics is inherently cyclical and that therefore we are inevitably headed for a downturn. Others, however, do not believe that a crash will necessarily follow. 'Not only do those arguments take no account for the fact that the situation today is different from that of 10 years ago in the sense that interest rates are relatively low and there has been a substantial reduction in unemployment levels, but they also miss the fact that many of today's players were around at that time and have a more experienced understanding of what constitutes a high-quality business that can support the levels of leverage currently appearing in the market place,' says Wilson.

Despite continuously increasing multiples, stories of bankers becoming more discriminating about deals and even walking away from transactions when they are unsure about the quality of the credit are also becoming more common. Private equity funds have also been reported to turn down debt packages on the grounds that these would not give the company room to breathe. 'Forward thinking sponsors are taking less debt from underwriting banks in exchange for greater flexibility and equity protection terms,' comments Guise.

Furthermore, big bang theories imply that one major default will automatically induce banks to engage in herd behaviour and reduce multiples across the board. 'This scenario depends on what causes the default,' says Bulmer. 'If a corporation is the first to collapse because of a downturn in the overarching economic climate or increasing interest rates, we can expect banks to turn more conservative in their lending strategies. But if the default is due to deal specific issues, the overall impact on the leveraged finance market will be minimal,' he says. Milders agrees: 'That would be unlikely as banks are likely to say, "Of course that went wrong but we would never have made that mistake."' He admits that if four or five transactions were to go sour in rapid succession, that situation would be different, but adds that the larger transactions are usually capable of sustaining large multiples. In addition, Bulmer remarks: 'Institutional investors have a built-in loss ratio and hedge their risk, which makes them less vulnerable to individual defaults and thus less susceptible to herd behaviour tendencies.'

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If there is a substantial risk of default, however, it appears that this is most likely to occur in smaller companies that are leveraged aggressively as competition in the market is driving up multiples across the board. 'A large company that realises a strong cashflow in a non-cyclical sector and that can increase in value significantly will be able to sustain much higher multiples than a small company operating in a cyclical sector, certainly if the private equity house decides to take on a less hands-on approach,' says Milders. Magnusson agrees: 'In some cases, average companies secure debt structures that should really only apply to outstanding businesses. It is very unwise to copy a structure that may be appropriate for a strong business and apply it to a mediocre one.'

Another consequence of rising debt multiples is that banks will want to hold less of the paper themselves. Given the current interest in leveraged finance, syndication is not particularly difficult, but a larger variety of participants inevitably makes the negotiating process more diffuse. 'This can create an impasse when important decisions must be taken which could result in unnecessary bankruptcies,' says Matthijs Mondria of Rabobank International. The fact that these structures are becoming increasingly back-end loaded may also mean that repayment problems are shifted onto the long term. 'Significant repayment issues may become clear when amortisation levels become meaningful,' says Bulmer.

There are also the risks that come with some of the newer entrants into the market. 'Bankers with less experience may well make less sensible investment decisions,' says Wilson. Some players also fear that many of the more recent investors will not want to participate in a work-out and will sell their debt on the secondary market at the first sign of trouble. That would be good news for distressed debt traders, but is a scenario which buyout houses will aim to avoid. Hedge funds in particular are the cause of many private equity



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Mark Milders
ING Acquisition
Finance

players' concerns. 'Hedge funds operate on a very different basis than traditional banks and have different motivations for their investments,' says Wilson. Many investors share the view that trading and betting is not likely to be conducive to private equity. Buyout groups, therefore, increasingly attempt to tighten documentation to ensure that its consent is required for every transfer or even attempting to prohibit transfers to certain investors. This makes the position of banks more difficult. Few lead banks will claim that winning mandates is hard, but there needs to be enough protection in the documentation to ensure that they can successfully syndicate the investments.

With more capital flowing into the private equity sector, it is clear that the stakes have been raised. Leveraged finance providers have to be increasingly vigilant to ensure the viability of their transactions in a climate which has heated up. The current situation is unlikely to be sustainable, but the question is whether the bubble will burst or deflate towards what is perhaps a more realistic situation. The debt market now benefits from being more mature than in the late 1990s and awareness of potential pitfalls has come with experience, but the success of the sector remains highly dependent on the macroeconomic climate. For the foreseeable future, however, private equity players are unlikely to be short of leverage provision.

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Last year the number and value of leveraged buy-outs (LBOs) in Europe reached a record level, EUR 117 billion. This year is shaping up to be even bigger. Apparently buy-out groups regard the old world, especially continental Europe, as a land of promise. Germany in particular seems to hold such promise. Strikingly prominent, the German mid-market has put itself into perspective exceeding all expectations so far and indicating lush prosperity for the future. Yet, operating in the German mid-market is not necessarily an easy option: It requires good contacts, local knowledge and a hands-on approach to developing business.

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Subordinated debt – flexing the odds

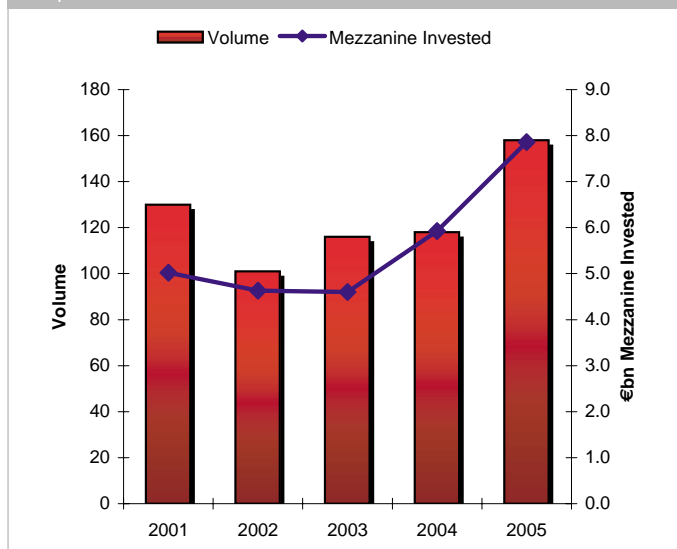
BY CATHERINE CRAIG

THE PAST FIVE years have seen a paradigm shift in the European subordinated debt market. Increasing commoditisation of subordinated instruments, driven in no small part by the stellar rise of private equity as an asset class, has created an environment where demand outweighs supply. €116.5bn went into private equity during 2005, of which €7.86bn was mezzanine. Trading on strong historical returns, sponsors are pushing up leverage on deals to enter an unprecedented cycle of risk.

Pitted against increasing competition, subordinated lenders are forced into new risk dimensions themselves and with interest rates unlikely to see a dramatic rise, this trend looks set to endure. 'Since mezzanine's popularity took over from high-yield bonds in the late 1990's, it has been deployed to maximise growth and boost profitability through the flexible prepayment terms and heavily deferred repayment structure it offers,' comments Stephen Mostyn-Williams of smwlaw. Nevertheless, as the scramble for subordinated paper has grown to reflect market liquidity, it could be said that mezzanine's flexibility has been exploited and left poorly protected against aggressive conditions. This has led to an overall depreciation in the quality of this high-risk instrument (see figure 1).

Over the past few years, a myriad of factors have conspired to squeeze lenders' expectations in terms of pricing and, correspondingly, returns. Increased competition for subordinated paper from CDOs, hedge funds and institutional investors has been a strong contributor to this axis. 78% of total mezzanine issuance in 2005 was warrantless,

Figure 1: Volume, €m mezzanine invested and total €m value of European mezzanine deals



according to Fitch, diminishing equity upside. Additionally, the established recurrence of second lien as a regular strip of debt between senior and mezzanine notes is leading to deeper subordination on repayment and, in many cases, diluted returns. Second lien accounted for 50% of all mezzanine issuance in 2005. Often pitched by the arranging banks as a 'stretched senior' facility, in reality it is a subordinated instrument which not only relegates mezzanine down the repayment spectrum, but is also used to drive up leverage multiples, thin down equity strips and consequently ramp up the overall risk on deals. In some cases, mezzanine investors are even compelled to take a second lien interest in order to access the more high-yielding mezzanine strip – a trend which, aside from reflecting the rampant competition in the market, diminishes lenders' risk-reward ratios.

In an increasingly delineated market, with deals breaking down into small-, mid- and large-cap segments (<€50m, €50-250 and >€500m respectively), differentiation between investor groups remains possible. In the large-cap market, allocation of subordinated paper is heavily driven by syndication processes run by MLA banks. Since arranging banks will often syndicate almost all subordinated debt off their own balance sheets, CDOs such as Alcentra and M&G, large banks like Royal Bank of Scotland and Bank of Scotland (when not arranging the deal) and a number of insurance funds and independent specialist funds such as Intermediate Capital Group (ICG), which also pitches for arranger roles, are the main players at syndication. This can lead to a misalignment of interests in some cases since arranging banks are under-incentivised to negotiate attractive terms if they are not holding onto the risk. As deal sizes in this €500m+ bracket become more ambitious and leverage multiples more exotic, mezzanine tranches are also growing. Both KKR's

buyout of French directories business Pages Jaunes and Warburg Pincus's acquisition of Casema and Essent Kabelcom involved the issuance of over €1bn of mezzanine.

By volume, mezzanine deals continue to be concentrated in the mid-cap. It is also within this size-bracket that the majority of independent providers tend to be most active (see figure 2). Operating in this bracket are MezzVest, Mezz Management, Indigo Capital, European Capital, Hutton Collins and ICG, amongst others. Traditionally strong geographical regions such as the UK and France are also being caught up by other historically less dominant markets. Germany, for instance, has seen a big rise in mezzanine quantities. 'Virtually all deals we see over €150m in size attract a mezzanine strip,' comments Julia Müller of White & Case, Frankfurt. Southern Europe and the Nordics have also seen a big lift in figures, particularly in the mid-cap segment. Here it remains possible on a case-by-case basis to buck downward pricing trends and to achieve structures more in keeping with traditional expectations. Whilst warrants are largely seen as a rarity in today's market, some independents continue to exercise patience, leveraging relationships and long-term commitments to negotiate warranted paper. An example is Indigo Capital's investment in walter TeleMedien alongside Gilde.

The erosion of warrants and the cash-pay elements of mezzanine through a downward flex on pricing are nevertheless a worrying phenomenon for investors across all segments of the market. Combined with ever-increasing leverage multiples, the overall risk profile on even the most promising deals is steadily being ratcheted up. Along with expanding parameters in terms of size, mezzanine is also changing shape to suit the demands of a bull market. This shift must be balanced against investors' return expectations – a challenge where the demand for paper commonly equates to downward flex on pricing. As a traditionally privately traded, un-rated floating rate instrument with limited prepayment penalties, mezzanine has historically fared best under high-risk conditions which balance its return expectations. Paradoxically then, prevailing benign economic conditions and low perceived default rates (often helped along by loosened covenants) are, on the whole, bad news for mezzanine's high risk-return profile. This leads one investor to comment that the fall in average mezzanine spreads recorded by unquote",



'In some highly competitive deals, senior A-tranches are being dispensed with in favour of using second lien to make up the shortfall.'

Stephen Mostyn-Williams
smwlaw



'Warrants are basically unpopular amongst equity sponsors because they dilute their equity share.'

Katharine Belsham
ICG

from 10-13% three years ago to 8.5-10.75% today, is justified given today's low defaults and well-positioned, cash-generative companies. 'Historically, mezzanine has made unrealistically high returns,' he comments, 'as a secured instrument it is not really justifiable to have the kind of spreads seen in the 1990's – what we're seeing is a rebalancing of risk-return.'

This buoyant market is characterised by shorter holding periods, the use of structured finance to draw down liquidity through refinancings and recapitalisations, and a high turnover of secondary and tertiary deals. 'On the face of it, this generates a high quantity of opportunities for mezzanine providers,' says Nicole Waibel of Indigo Capital. However, mezzanine providers are challenged by the high leverage and multi-layering of subordinated debt on high-quality deals so that ultimately, the quality of return they offer is compromised. In this pressurised climate Indigo looks to do only warranted deals, finding opportunities in higher risk sectors less aggressively leveraged by banks, turnaround situations or asset-sparse businesses. This takes nerve and a deep understanding of the credit risk on an asset due to the current competitive conditions.

The decline of warrants is a sign of an indolent market, enjoying fat liquidity and enabling equity sponsors to dictate terms. Warrantless mezzanine, however, is issued on the assumption that a deal will perform well over time. This, as Katharine Belsham of ICG points out, is not always a given. 'Warrants are basically unpopular amongst equity sponsors because they dilute their equity share,' she comments, adding: 'This is fine for the sponsor if a deal goes to plan, but if a business performs below expectations and cannot be sold, the rolled up interest will start to eat into an equity house's loan stock over four to five years. This is ultimately benefiting the mezzanine provider, so it has little incentive to put up extra cash-risk to improve a target's performance.' On a warranted deal, interests are aligned so that the management, equity house and mezzanine provider would traditionally share the equity gains, says Belsham. Put bluntly, traditional warranted mezzanine may fair better if the market takes a knock and risk profiles increase once more.

Recycled mezzanine deals through secondary and tertiary transactions or refinancings accounted for 68% of total issuance in 2005, according to Fitch. In

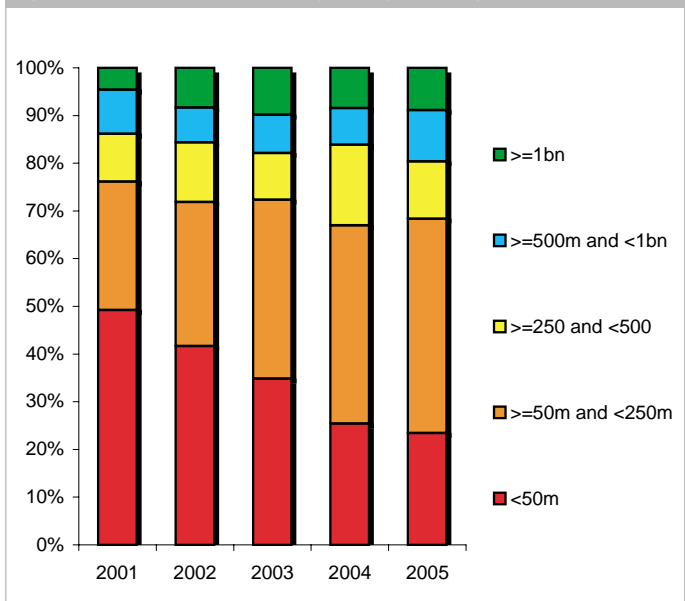
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addition, whilst the dramatic increase in refinancings over the past three years is a sign of strong-performing, cash-rich investments, mezzanine's negligible security against prepayment means that the best-performing deals are not always the most profitable. 'Mezzanine used to have prepayment fees of 2% in the first year, falling to 1% in the second across the board. Now in some cases we are starting to see both the fee being reduced and the period during which it applies shortened. It also used to be the norm that if a deal was refinanced the original leverage provider would continue the mandate,' comments Julia Müller of White & Case, Frankfurt. She adds: 'This can no longer be assumed, so that recycling of deals also invariably triggers a renewed competitive process.'

On average refinancings occur after 24 months, however, some happen in as short a time as six months. Unwarranted mezzanine's minimal security against prepayment on refinancing leaves it vulnerable to being shunted down the repayment spectrum with second lien or having its pricing flexed down at the very least, whilst in the worst case being paid off and removed from the balance sheet altogether. This is not just a trend on large deals, but is happening in the mid-cap segment. One adviser reports that it is becoming popular for sponsors to conduct substantial add-on acquisitions within just a few months of the closing of the original transaction, thereby requiring further financing. This leads to discussions about restructuring the debt package to increase the senior portion and introduce a second lien portion, not only in order to provide the extra financing required for the add-on acquisition but also to reduce or even dispense with the mezzanine tranche at the same time. Anecdotal evidence would also suggest that the mid-cap size bracket is beginning to see downward flexing of second lien, where mezzanine has been excluded from the leverage structure altogether. Non-amortising second lien can, unlike senior notes, be prepaid without renegotiations. 'In some highly competitive deals, senior A-tranches are being dispensed with in favour of using second lien to make up the shortfall,' comments Mostyn-Williams, who specialises in advising investors.

Warrantless mezzanine providers are therefore using new methods to achieve upside and win the returns their investors expect of them. PIK options – seen largely as debt of last resort – are being structured in conjunction with diluted mezzanine-second lien blends to boost returns in some cases. However, in the event of a refinancing, PIK coupons are likely to be the first form of debt to be repaid since they are the most expensive. This diminished security, says Belsham, is a slippery slope for mezzanine providers and a further reason to be cautious about only doing warrantless tickets. 'If you only invest in deals which perform well and are highly cash-generative, the risk created by refinancings is that you lose your upside position after too-

Figure 2: Volume of mezzanine buyouts by size range (€)



short a time and end up with no buffer against the poorly performing deals,' she remarks. This is the curious paradox of unwarranted mezzanine's success – in today's climate it might almost be seen as more prudent to seek out deals that are likely to go sideways. Mezzanine providers are trying to combat this risk by buying into equity when the opportunity arises. Some, like Indigo and ICG, have always done this and with some success. 'Indigo has always taken a small equity-portion alongside its mezzanine allocation in higher upside deals,' comments Waibel. ICG, which, as a result of its diverse investment strategy, recorded profits up 72% in the last financial year, also has a portfolio of £220m of equity investments.

Mezzanine's limited downside protection is an issue in need of resolution. While market resonance suggests that it has begun to mirror the less costly, commoditised character of the high-yield bond, it lacks all the security that this instrument affords. The next step to combat the depression of mezzanine returns to mirror those of high-yield bonds could be to demand some of the call-protection these offer, perhaps by adding a one- or two-year non-call facility. The viability of this proposition depends heavily on the market's openness. At the other end of the spectrum, however, the high-yield bond market is also taking on mezzanine-like characteristics, with providers like BNP Paribas having recently launched a floating rate high-yield bond. As pricing on leverage remains the dominant driver for squeezing the maximum return out of a deal, the subordinated debt market is likely to retain this evolutionary dynamic over the next 12 months.



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Syndication – choose your partners carefully

BY RICHARD MOON OF IE CONSULTING

PRIVATE EQUITY HOUSES are becoming increasingly concerned about syndication of debt to hedge funds. Commercial and investment banks have continued to focus their attentions on leveraged loans and low default rates have encouraged banks to underwrite more aggressive debt packages. Although banks are keen to underwrite primary issues, increased restrictions on the levels of debt that European banks can hold on their balance sheets has enhanced the need for syndication. These trends have enabled hedge funds, which are seeking attractive risk-adjusted returns, to expand their exposure to the market. In work-out situations, buyout groups fear that syndication to hedge funds may result in loss of control of their companies.

For some time, industry commentators have been predicting a peak in the debt market. European private equity's seemingly insatiable appetite for loans, fuelled by a surplus of un-deployed capital, has continued to put upward pressure on prices in 2005-2006. 'If I had told people in 2003 that traditional manufacturing businesses were going to be leveraged at north of 6.5x next year's adjusted EBITDA, people may well have laughed,' says Nick Atkinson, head of leveraged finance at Calyon. 'If I had said that the market would be short of paper in deals done at this level, people may well have had a seizure,' he adds.

Higher leverage and associated levels of risk mean that banks are now eager to sell down debt to a whole range of investors. European banks have traditionally been reluctant to syndicate to hedge funds and CLOs because they prized their relationship with clients. However, regulatory pressure to reduce the risk on their balance sheets has put an end to such cautionary policies and has led to a steady rise in banks'



'Hedge funds in the European market will constitute an increasing proportion of the syndication market for leveraged loans over the next few years.'

Volkhardt Kruse
Dresdner Kleinwort

willingness to syndicate. The importance of hedge funds will continue to grow as the market for leverage loans grows aggressively over the short term. Volkhardt Kruse, head of leveraged syndication at Dresdner Kleinwort comments: 'Hedge funds in the European market will constitute an increasing proportion of the syndication market for leveraged loans over the next few years – the European market has a long way to go to catch up with the US.'

The clear distinction between banks, hedge funds and CDO/CLO fund managers that once existed is disappearing fast. Hedge funds are now one of the key drivers of liquidity. Credit funds, which held only 10% of the primary leveraged-loan market in 2000, account for almost half the market in 2006. Hedge funds look like they will be a permanent fixture in the leveraged-debt sector and have started poaching credit officers from banks to underline their intentions. However, many private equity houses believe that these opportunistic investors should not be playing such lead roles.

Easy availability of debt, combined with the bullish approach of lenders, is causing some investors to become over-confident and complacent notes Atkinson. 'Everything is getting sold, almost irrespective of the pricing on the debt or indeed the leveraged multiple that the debt carries,' remarks Atkinson, adding: 'After all, when you have been in the market for the last seven years, you have made substantial returns by saying 'yes'. It is almost as if we could have saved everyone a lot of time and effort, done away with diligence and just shipped out the cash.' While many bankers insist that current levels of syndication mean that no one bank will unduly suffer in the event of an economic downturn, some deem these levels too excessive.

Most concerns about syndication levels centre on the market's reaction to an economic downturn. Hedge funds and CDOs are not only buying loans from banks in secondary markets, but are also joining bank syndications, particularly in leveraged finance. In today's market, syndication is not a problem for lenders on leveraged transactions, since the majority of private equity-backed companies are strong businesses. In a sluggish economy, however, syndicate partners are likely to be more carefully selected, creating the possibility that banks will be left with an increased proportion of highly leveraged debt on their balance sheet. In addition to this, some companies are uncomfortable with hedge funds owning their loans – particularly since funds that take part in primary loan issuance could get access to the type of privileged information that used to be the preserve of the banks. Volkhardt Kruse does not believe this to be a problem, stating: 'All groups (banks, CDOs, hedge funds) are subject to the same confidentiality agreement, so that should not be a problem.'

The primary concern for most private equity players, however, is that heavy syndication will make it difficult to help distressed businesses. 'The problem arises when too wide a variety of institutions take too much of the paper,' says Atkinson. 'Diversification in a portfolio is important, but if a deal goes bad it will be difficult to implement a work out situation.' Hedge funds that hold increasing amounts of companies' debt may be more eager to cut their losses by pulling the plug on a borrower rather than helping it work through a restructuring or refinancing. Volkhardt Kruse highlights the concerns that many private equity investors' hold: 'They are concerned because hedge funds take a different view on risk, they are short-term investors with objectives which might not fit in with a long-term view taken by a private equity firm on a business.'

The increasingly sophisticated organisation of private equity transactions offers opportunity for alternative vehicles to enter the syndicate structure. Consequently, bankers have endeavoured to produce instruments that meet the demand of investors (particularly hedge funds) as well as those of the private equity houses. Over the past year, many buyout groups have looked at the possibility of structuring deals in such a way that would allow them to repay early if they wished by using payment-in-kind (PIK) loans. Although several new product types have entered the market recently, Kruse does not expect this trend to continue in the immediate future: 'I do not see more products coming to market in the short term. PIK and second lien are now widely used in the European market and the use of these products has been driven largely by investor demand.'

Distressed debt is also a logical area of interest for hedge funds. Historically, there has been some overlap in the distressed area between hedge funds and private equity. A hedge fund would dabble in private equity while a private equity fund would try its hand at investing in more liquid, distressed investments. However, to satisfy the demand of such investors, distressed debt would have to move away from its niche area. Volumes would have to massively increase as it currently represents too small a proportion of the total debt market to divert attention away from lucrative leveraged deals. There are bound to be a handful of deals that struggle to meet their covenants and have to renegotiate, but it is unlikely that distressed debt will command the same attention from investors as buyouts, venture and mezzanine.

It seems that both hedge funds and credit funds have moved to take advantage of the attractive yields currently being offered in the leverage-loan market. These funds provide liquidity to the market and many banks seem happy to use them as syndicate partners. At present, the majority of private equity players appear unworried by these developments and are putting in few constraints to restrict banks syndicating debt to such funds. 'It may be very difficult to restrict syndication to certain groups or impose restrictions on sales in the secondary markets in deal documentation,' explains Kruse. In the current benign economic climate, few private equity players deem these provisions necessary. However, if the European economy was to slip into recession, private equity players might begin to reassess the threat posed by hedge funds and put increasing pressure on banks regarding syndication partners.



Richard Moon is part of the IE Consulting team. IE Consulting is affiliated with the Alternative Assets division of Incisive Media (formerly Initiative Europe) and the Asian Venture Capital Journal in Hong Kong, which has been analysing and commenting on the venture capital and private equity markets for almost twenty years. Managed as an independent unit, IE Consulting works across the entire venture capital and private equity cycle, delivering insight and decision support to practitioners across the industry. We also undertake significant work for institutional asset managers and hedge funds. Projects undertaken include providing materials to be used in the fundraising process and in PPM documents, as well as market analysis to aid strategic decision-making in areas such as market positioning, deal origination and investor communication.

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What are the challenges facing the private equity market at the moment from a debt perspective?

JAMES STIRLING INVESTEC

Investec Growth & Acquisition Finance believes that the low interest rate environment of recent years is unsustainable and this is the biggest single challenge the market will face. The UK is experiencing creeping inflation, the full effect of which is beginning to be felt more keenly by the consumer than the CPI statistics might suggest and accordingly, pressure is mounting on the Bank of England to continue raising interest rates. If rates do rise, the 'cheap' debt that has been around for the last two to three years will not be so plentiful and this will impact on the market in a variety of different ways: lower valuations, lower returns and possibly fewer deals funded by private equity. As a double whammy, companies will have to work even harder in the face of a worsening economic environment to maintain historic profitability levels. Essentially, with higher interest rates, banks are going to be a lot more conservative about the multiple of EBITDA they will lend. Even existing investments are not immune: interest hedging strategies may need to be reviewed for adequacy, those original funding structures that were predicated on bank refinancing in latter years may now require further equity support in order to achieve this and exits may be harder to find.

What impact have these conditions had on mezzanine providers?

Low interest rates have given rise to a situation where senior lenders have been willing to stretch their funding. Banks have been quite aggressive in doing this and have encroached on what had been traditionally considered the mezzanine space in a leveraged structure, pushing mezzanine providers further up the risk spectrum.

How has Investec responded to this situation?

We have had to be flexible in order to continue offering a product that remains attractive to private equity clients. We therefore developed a 'preferred equity' product, which is essentially an evolution of our mezzanine product, but sits at an equity level and was developed so as to offer a potentially attractive alternative to equity syndication. Basically, we acquire loan notes but take a less than pro rata shareholding in return for priority ranking. This allows the lead equity investor to get a disproportionately larger equity stake for every pound it invests. To date, Investec has done this in four deals, most recently the £40m buyout of Superglass Insulation, a glass wool insulation manufacturer backed by NBGI Private Equity.

How has this affected the returns Investec has targeted?

Obviously, since we find ourselves operating at a higher risk level in the funding structure, where we were previously targeting an IRR in excess of 14% on a mezzanine loan, our targeted returns have had to rise accordingly.

Interview in 60 seconds BY SARAH YOUNG

What are the challenges facing the private equity market at the moment from a debt perspective?

RICHARD COLLINS
INDIGO CAPITAL

There are two key challenges: firstly, are the current unprecedented levels of debt being offered by the arranging banks appropriate and sustainable? Purchase prices are being driven by, in our view, inappropriately high debt multiples, with debt providers no longer expecting to see their debt repaid through cash flows but instead providing bullet debt and relying on the exit for the repayment. With companies not deleveraging over the first couple of years in the way they used to, the risk of covenant default is greater. Private equity sponsors also have to ask themselves whether the same level of valuation multiple will be there at the exit if the debt multiples come down. The second challenge is who holds the debt and what implications that will have for private equity groups in the future. With CDOs, hedge funds and other institutions buying the majority of debt in the primary and secondary markets, and distressed debt funds becoming increasingly active, should conditions change for the worse, a private equity firm will no longer be able to rely on relationship banks when it needs to renegotiate a debt package. The new debt owners will have a more aggressive approach, some of them with a clear 'loan to own' strategy. We are yet to see the impact of today's market conditions over the full length of the credit cycle.

What impact have these conditions had on mezzanine providers?

Mezzanine providers are lending at EBITDA multiples in 2006 that were the purchase price multiples in 2003, so there is an obvious negative impact on risk/reward. There has been massive growth in both the volume of mezzanine demanded and correspondingly the number of participants in the market. The large buyout trends have trickled down to the mid-market, in which Indigo operates.

How has Indigo responded to this situation?

Indigo is quality and not quantity-driven and, believing that we are at or near the peak of the credit cycle, has been particularly selective over the past 12-18 months. We have chosen to focus more on complex transactions that are less attractive to the banking community. For instance, we have recently closed two transactions which have not involved any senior debt. We are prepared to spend more time to understand 'story' deals, such as companies which might have troubled trading histories or which are in difficult sectors, the types of deals which a bank syndication committee will hesitate to approve. We are also keen on transactions where flexibility of the mezzanine product is required and we continue to work on sponsorless deals, such as financing acquisitions for private companies.

How has this affected the returns Indigo has targeted?

While all mezzanine players, like the equity houses, know they are not going to make the returns they made in the 1990s, there are still attractive risk-adjusted returns to be made. We simply have to work harder on more complicated transactions in order to maintain higher returns.



Interview in 60 seconds
BY SARAH YOUNG

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The better ist the enemy of the good. *(Voltaire)*

Positive developments are no coincidence, but the result of knowledge, experience and know-how – and particularly their felicitous alliance. That is what we believe to be good advice.

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